

MILITARY DEPARTMENT
OFFICE OF THE ADJUTANT GENERAL
9800 Goethe Road - P.O. Box 269101
Sacramento, California 95826-9101



December 28, 2009

California Department of Finance
Office of State Audits and Evaluations
ATTN: Mr. Michael C. Genest, Director
300 Capitol Mall, Suite 801
Sacramento, CA 95814

Dear Mr. Genest:

In accordance with the Financial Integrity and State Manager's Accountability Act of 1983, Government Code Sections 13400 through 13407, and as agency secretary, I submit the enclosed report describing the system of internal control for the biennial period ended December 31, 2009.

Should you have any questions or require additional information, please call Ms. Debbie Richardson, Audit Director at (916) 854-3686.

Sincerely,

A handwritten signature in black ink, appearing to read "William H. Wade II".

William H. Wade II
Major General
The Adjutant General

Enclosure
as

CALIFORNIA MILITARY DEPARTMENT

Organization Code 8940



Financial Integrity and State Manager's Accountability Act Report of the System on Internal Controls

Major General William H. Wade II, Agency Secretary
December 2009

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**CALIFORNIA MILITARY DEPARTMENT
ORGANIZATION CODE 8940**

REPORT OF THE SYSTEM ON INTERNAL CONTROL

INTRODUCTION

The California Legislature passed the Financial Integrity and State Manager's Accountability Act (FISMA) of 1983, Government Code (GC) Sections 13400 through 13407, to reduce resource waste and strengthen controls. Recognizing the significance and importance of effective systems of internal control, FISMA requires the head of each state agency to institute and maintain effective systems of internal controls, evaluate the efficiency of these controls on an ongoing basis and report on the adequacy of the agency's system of internal control by December 31 of each odd-numbered year.

Properly monitored internal controls are the first line of defense in safeguarding assets and in preventing and detecting fraud. In addition, these controls help ensure that actions are taken to address risks and are an integral part of the California Military Department's (CMD) accountability and fiduciary responsibility. An adequate and efficient internal control system also provides the foundation upon which a structure of public accountability is built, and should be designed as a process effected by management and staff to reasonably assure that the following are achieved:

- Reliability of financial information (Transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of reliable financial statements).
- Promoting compliance with applicable laws and regulations, and
- Effectiveness and efficiency of operations.

This report contains an account of vacant positions and a description of each of the following interrelated components of the CMD's system of internal control.

- Control environment;
- Risk assessment methodology;
- Evaluation of control activities (Internal Audit Activities);
- Information and communication methods; and
- Monitoring.

BACKGROUND

The CMD is a broad, community-based organization with an operational and functional mission unlike any other state agency. To maximize readiness, federal and state mandates stipulate that the CMD organize, resource, and train a joint force capability (Army and Air National Guard components) to support and serve the local community, the State and the Nation, placing this agency in a sensitive and high profile position. The federal missions include operations in support of the Army and Air Force for peacekeeping and wartime missions. State missions primarily include disaster relief and community support. The CMD is also responsible for the command, leadership, and management of four unique youth programs located throughout California. These programs are financed with federal, state, and local funds.

The CMD is led by The Adjutant General (TAG), and who was appointed by Governor Arnold Schwarzenegger on September 1, 2005, and serves as the Agency Secretary responsible for supervising the Army and Air National Guard Joint Forces within the CMD.

CONTROL ENVIRONMENT "TONE AT THE TOP" AND COMMUNICATION

As a part of the internal control system, the control environment sets the tone of an organization and is the foundation for the overall system of internal control. Communication is also an essential part of this system.

TAG sets the "tone" and is ultimately responsible and assumes ownership of the internal control system within the CMD. TAG expects senior leadership to be accountable for implementing effective internal controls over their areas of responsibility, prevent wasteful spending, and ensure the process of transparency. This internal control process includes monitoring the CMD's mission and strategic plan, and fostering an environment that encourages the highest levels of integrity as well as personal and professional standards.

Weekly Headquarters Update Briefings are held with TAG, the Assistant Adjutant General (AAG), senior leaders, directors, and supervisors to report relevant mission and strategic information, workloads, staff actions, policy and governance issues. TAG holds every member of the CMD accountable for their role in the system of internal control and frequently communicates to all levels the importance of following policies and procedures, showing intolerance for discrimination, harassment of any sort, fraud, waste, abuse; and emphasizing that violation of policies and rules will never be tolerated. Through memorandums, directives and communiqués via the CMD's intranet, TAG periodically provides information and reminders to employees regarding the Governor's Waste Watchers Website and Whistleblower Protection Law.

Early on TAG established strong vocal support for the Military Department Internal Review Office (MDIRO). The MDIRO Director meets regularly with TAG and the AAG to provide updates on MDIRO's activities and/or discuss critical departmental issues, review and obtain approval of planned audit activities, and provide solutions or mitigating action to reduce and eliminate risk.

To better understand the functions and services the MDIRO offers not only TAG but the CMD as a whole, it is suggested that the MDIRO's mission statement and audit services be available via the CMD's portal website.

REPORT ON VACANT POSITIONS

Government Code (GC) Section 12439 mandates that the State Controller's Office (SCO) identify and abolish vacant positions that are vacant six consecutive monthly pay periods within one fiscal year or between two consecutive fiscal years. The CMD currently has a total of 269 State Civil Service (SCS) positions, which includes 244 filled positions and 25 vacant positions. It should be noted that the CMD was advised by the SCO that all State Active Duty (SAD) positions are exempt from this requirement.

Based on the data received from the CMD's State Personnel Office (SPO), during the period July 1, 2008 through April 8, 2009, the CMD processed a total of 62 STD 607s to either reestablish or establish positions. Of the 62 positions, 15 positions were disencumbered and 15 were changed from 100% State General Funds (SGF) to 50% SGF and 50% federal funds using a personnel transaction code "120". The CMD also eliminated 11 positions pursuant to the Governor's 7,000 Position Reduction target. The MDIRO will review all STD 607s as a part of the upcoming SPO audit.

Due to inadequate SCS staffing levels within the SPO and the most recent furlough order, when vacancies occur or new positions are established it usually takes some time to complete the hiring process and adequately fill them within the required timeframe.

RISK ASSESSMENT METHODOLOGY

Assessing risk is an important component of the internal control system and a major part of the MDIRO activities. The MDIRO has implemented a Self Assessment Program (SAP) and developed a Control Self Assessment Questionnaire (CSAQ), a tool for directors and supervisors responsible for managing and performing the work to evaluate the adequacy of their internal controls. The SAP has three phases:

1. Directorates conduct a self assessment of their operations and certify the results;
2. The MDIRO reviews and analyzes the results; and
3. The results are verified by the MDIRO during any audit of the directorate.

On an annual basis, directors and supervisors are required to complete a CSAQ by evaluating, documenting, and certifying the system of internal control within their area. The CSAQ includes "yes" or "no" responses that pertain to the control environment and strategic operations; expenditure controls and compliance; data integrity; human resources; safeguarding assets; and disaster recovery. Any "no" response requires an explanation in the comment field. These responses indicate that internal control procedures may not be as strong as designed. Directors and supervisors are encouraged to maintain a copy of the CSAQ to use as a tool to periodically assess risks within their areas and take appropriate action when necessary, as action is the most important task of the CSA process.

The MDIRO reviews and analyzes the results to obtain a working knowledge of the existing internal control structure and identifies risks. Depending on the level of risk identified, the MDIRO performs an audit or follows up on procedures.

EVALUATION OF RISKS AND CONTROLS (INTERNAL AUDIT ACTIVITIES)

The control activities component of internal controls includes, but is not limited to, 1) ensuring policies and procedures are in place, 2) proper segregation of duties, approvals, reconciliations, exist, and that 3) safeguarding of assets and internal validations are established to achieve the organization's objectives. The MDIRO and external audit organizations also contribute to the effectiveness of internal control systems. Although they are not responsible for establishing or maintaining these systems, they provide useful information through evaluation and recommending process improvements.

In an effort to comply with FISMA, the MDIRO performed the following activities during the period January 1, 2008 through November 30, 2009. These audit activities were primarily identified, based on the available audit resources, through a CSAQ analysis and an identification of high risk transactions.

1. Youth Programs - Oakland Military Institute (OMI). The MDIRO performed an audit of the State general funding used for OMI's personnel and operating expenses to determine if the duties of CMD and OMI were 1) clearly defined; 2) financial operations conducted as approved by the Legislature in accordance with policies and procedures established in the SAM; 3) transactions executed in accordance with management's authorization; 4) recorded properly to permit the preparation of reliable financial reports; and assets; and 5) safeguarded against loss from unauthorized use or disposition.

Condition/Audit Results: *The MDIRO found that the Youth Program Director's (YPD) program lacked efficient and effective internal controls and fiscal oversight in properly administering the CMD's funding of the school's operations. The CMD accepts the risk and believes, "no reimbursement is necessary from OMI as the money spent on cadre personnel, albeit not those on SAD status". The MDIRO disagrees. However, the CMD has made immediate changes, which included executing clear and concise contracts and closely monitoring expenditures. Based on physical observation and a review of the OMI's school accountability report and other data, the MDIRO notes that the OMI is carrying out its mission by successfully providing a structured rigorous academic program, as well as graduating a large percentage of cadets who have entered the California State and University of California systems and top private and public universities nationwide.*

Risks: *To mitigate the risk of continued violation of state regulations, department policy, fraud, and loss of resources, the YPD management should periodically monitor all expenditures to ensure compliance.*

Corrective Actions to Date: *Follow-up activities will be performed during the next reporting period to determine if all other recommendations have been implemented.*

2. Office Revolving Fund. The primary objective of this audit is to ensure that efficient and effective internal controls are in place over the Office Revolving Fund (ORF) as it relates to travel. The audit includes an assessment of compliance with applicable State regulations and

CMD policies and procedures, and determines 1) if written policies and procedures exist for administering and controlling travel expenses 2) travel expenses are properly authorized, supported, relevant, reasonable, and 3) all travel reimbursements comply with State rules and regulations.

Condition/Audit Results: *Based on the preliminary results reported to CMD executive management and program management in December 2008, the MDIRO expanded the audit scope an additional year to include current operations. The preliminary results, as reported to management, disclosed deficiencies in internal controls, numerous instances of non compliance, a weak control environment, lack of communication, and weak fiscal oversight over the travel program, which allowed potentially fraudulent, unallowable and questionable transactions to occur. The audit also identified widespread reimbursement inconsistencies and violations of state regulations, rules, and policies.*

Corrective Action and Risks: *Although the CMD implemented the California Automated Travel Expense Reimbursement System (CalATERS), which incorporates CMD policies, manually calculates claims, updates travel rules, and edits and audits claims electronically, the responsibility rests on the employee, the supervisor and management to report and verify information that is accurate, relevant, appropriately authorized, includes proper support documentation, and complies with current policy. If proper internal controls are not implemented immediately, continued violation of policy, loss of money, inaccuracy of financial data, negative publicity, or public distrust could occur.*

Planned Audit Activities: The MDIRO will continue to perform audit activities to determine whether the CMD's network of risk management, control, and governance processes, as designed and represented by management, are adequate and functioning properly. For an example, in January 2010, the MDIRO plans to conduct an audit of the CMD's SPO Directorate. The audit will include a review of the personnel and payroll functions to determine if:

- Internal controls are adequate;
- Policies and procedures are in place for proper hiring, training, evaluating and promoting SCS and SAD employees;
- Payroll transactions are processed accurately and timely; and
- Policies and procedures are in place and consistently followed regarding management's response to non-performing employees and that appropriate corrective action is taken to resolve disciplinary issues.

The audit will also include procedures to review the finding not yet implemented and validate the actions taken by the CMD management based on the Bureau of State Audits (BSA) audit report number 2005-136 regarding inadequate personnel management of SAD employees.

The MDIRO will continue to perform monitoring, audit coordination, and consultation services. While the MDIRO is carrying out important, innovative work, it faces two challenges toward accomplishing the goals of the planned audit activities: 1) in comparison to the areas subject to audit, the MDIRO is a very small office of one working audit director and one auditor and 2) the available audit hours have been significantly reduced due to mandatory furloughs for State Civil Service employees. However, despite these challenges, the MDIRO will continue to provide effective and efficient deployment of internal audit resources in performing examinations and evaluations.

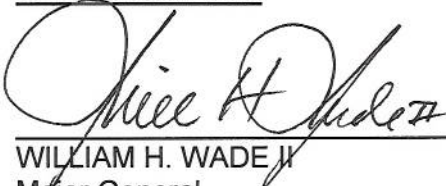
CONCLUSION

A well designed and executed internal control review system is intended to provide management with reasonable assurance that the internal controls are working as intended, risks are minimized, the system meets established standards, and management is meeting its goals and expectations. However, based on the audit activities performed during this reporting period, and the effect of the weaknesses described in the preceding section, the MDIRO cannot provide assurance that the internal control system throughout the CMD is operating efficiently.

TAG also believes that the strength of the internal control system is dependent upon the employee's attitude, understanding, and ability to effectively apply it. In this time of increased accountability and transparency, TAG understands that there is a greater emphasis on internal controls. Therefore, since the last reporting period the CMD has improved its operations by:

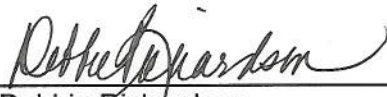
- Establishing the Equal Employment Office;
- Meeting the requirements of SB 1452 by establishing a framework in which the MDIRO is free to conduct their work independently. (To ensure audit independence, the MDIRO reports administratively to the Chief of Staff and functionally to TAG);
- Ensuring the MDIRO continues to perform evaluations of internal controls and other value-added audit services; and
- Implementing the CalATERS.

CERTIFICATION



WILLIAM H. WADE II
Major General
The Adjutant General

12/28/09
Date



Debbie Richardson
Audit Director
Military Department Internal Review Office

12/28/09
Date